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International Economic & Energy Weekly

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Perspective

Status of Gorbachev's Economic Program 25X1

The recently published 12th Five-Year Plan and guidelines to the year 2000 reaffirm previous indications that the revitalization of the economy through science and technology is General Secretary Gorbachev's highest domestic priority. He seems to realize that, despite the recent upturn in economic growth, substantial improvement in the economy's capability to create and use new technologies is still required for Moscow to recapture the higher growth rates of the first half of the 1970s and match the productivity of Western industrial powers. 25X1

To address these issues Gorbachev has set ambitious goals. Overall economic growth during 1986-2000 is to accelerate to almost 5 percent annually—double the rate achieved during 1979-84. Special emphasis will be placed on the same industries that have led industrial modernization efforts in the West—machine tools, robots, microelectronics, computers, and telecommunications. 25X1

To achieve these goals, Gorbachev has outlined a two-stage strategy. In the short term, he seeks to boost economic performance through "human factor" adjustments—new personnel, some organizational changes, a vigorous temperance campaign, and a renewed emphasis on discipline and improved worker effort. In the longer term, Gorbachev hopes that growth will be further accelerated as his nascent program to modernize plant and equipment and stimulate technological progress comes to fruition. Central to this program is the redirection of resources from new construction to retooling existing facilities. To provide the equipment necessary for retooling, investment in civilian machine building will grow in 1986-90 by 80 percent over that of 1981-85. By 1990 Moscow plans that 50 percent of all equipment in industry be "new." 25X1

The short-run prospects for at least moderate success for Gorbachev's program are promising. Economic growth in 1985 may be a full percentage point higher than in 1984. Much credit is due to better weather and a good agricultural showing, but Gorbachev's initiatives are no doubt having a positive impact. He has consolidated power faster than any of his predecessors and already has achieved a working majority in the Politburo, a rapid pace of cadre renewal, and the placement of key lieutenants to head Gosplan, the Foreign Trade apparatus, the Foreign Ministry, and the Council of Ministers. 25X1

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The long-term prospects for sustained improvements, however, are uncertain. The sweeping personnel changes, management reforms, and greater discipline may boost labor productivity for a year or so, but by themselves cannot sustain growth indefinitely. Furthermore:

- Reallocation of investment to machine building may squeeze other vital sectors threatening production bottlenecks.
- Investment in some consumer sectors may get short shrift, risking consumer discontent that will counter efforts to raise productivity.
- Exogenous constraints—labor shortages and increasing raw material costs—will remain severe.
- Hard currency constraints and Soviet problems assimilating and diffusing foreign technology will limit the potential contribution of imports to achieving goals.

Most important, Gorbachev is, so far, leaving the principal features of the economic system intact. This system was designed to operate most effectively under conditions of abundant resources, but it is ill prepared to generate innovation and stimulate efficiency in today's resource-constrained environment. [redacted] 25X1

If Gorbachev's plan to increase growth and accelerate S&T falters, he may consider bolder reforms, such as steps toward market socialism. His political momentum augurs well for his future ability to take bolder steps, and the ambitious nature of his goals increases the chances he will have to do so to avoid being seen as just another leader unable to make good on his promises.

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Soviets Outline Next Five-Year Plan [redacted] 25X1

The recently released draft plan for 1986-90 and guidelines to the year 2000 call for the economy to grow at average annual rates not achieved for more than a decade, and even faster during the 1990s. This growth is to come almost entirely from gains in productivity, but past campaigns to raise productivity have fared badly. Moscow's agenda offers hope for improvement, but not on the scale necessary to compensate for the increasing scarcities of basic resources. [redacted] 25X1

Ambitious Goals

As the 12th Five-Year Plan period begins the Soviets remain stuck in a decade-old economic slowdown. Although performance has improved in the last couple of years, the Soviet economy still cannot simultaneously maintain rapid growth in defense spending, satisfy consumer demand for more goods and services, generate enough investment for modernization and expansion, and underwrite client economies [redacted]

The new leadership apparently understands these limitations and realizes that overall economic growth must be increased substantially over its 2.5-percent annual average of the last five years to adequately address the conflicting demands. Gorbachev's earlier speeches had implied growth in GNP of at least 4 percent per year, and the General Secretary had remanded the draft plan three times for revision. The published draft calls for average annual growth of almost 5 percent during 1986-2000—3.5-percent annual growth for the rest of the decade, followed by rates in excess of 5 percent during the 1990s. Output in the vital industrial sector is to follow much the same pattern, rising from the 3-percent average annual pace of the current five-year period, to more than 4 percent during the period 1986-90 and more than 5 percent during the 1990s. These targets will be discussed and possibly revised prior to final approval, scheduled for late 1986. [redacted]

The plan goals are in keeping with Gorbachev's aim of immediately boosting economic growth through better management and increased discipline. Growth will be further accelerated as the impact of the "scientific and technological revolution" he envisions for the economy increasingly asserts itself. The plan makes clear that retooling industry with new and improved equipment is Moscow's number-one priority. The unusually detailed descriptions of machinery development and production plans suggest substantial inputs from Soviet technologists. [redacted] 25X1

Modernizing Industry—The Linchpin of the Plan

The plan calls for a cutback in new construction and a 50-percent increase in expenditures for retooling existing enterprises. Currently, 30 to 40 percent of all Soviet equipment has been in operation for more than 20 years, but, by 1990, the plan declares, one-third of all fixed capital—including one-half of all machinery—must be new. To meet this ambitious goal, machinery production—the main carrier of new technology—is to grow at 7 to 8 percent annually, rates not achieved since the early 1970s. Within machine building the high-technology sectors producing computer equipment, precision instruments, electrical equipment, and electronics are to receive special emphasis and grow at even faster rates. [redacted] 25X1

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Domestic machine builders will be hard pressed to meet these production goals:

- For industrial modernization to succeed, not only more, but also higher quality machinery must be produced. The machinery must be made to order

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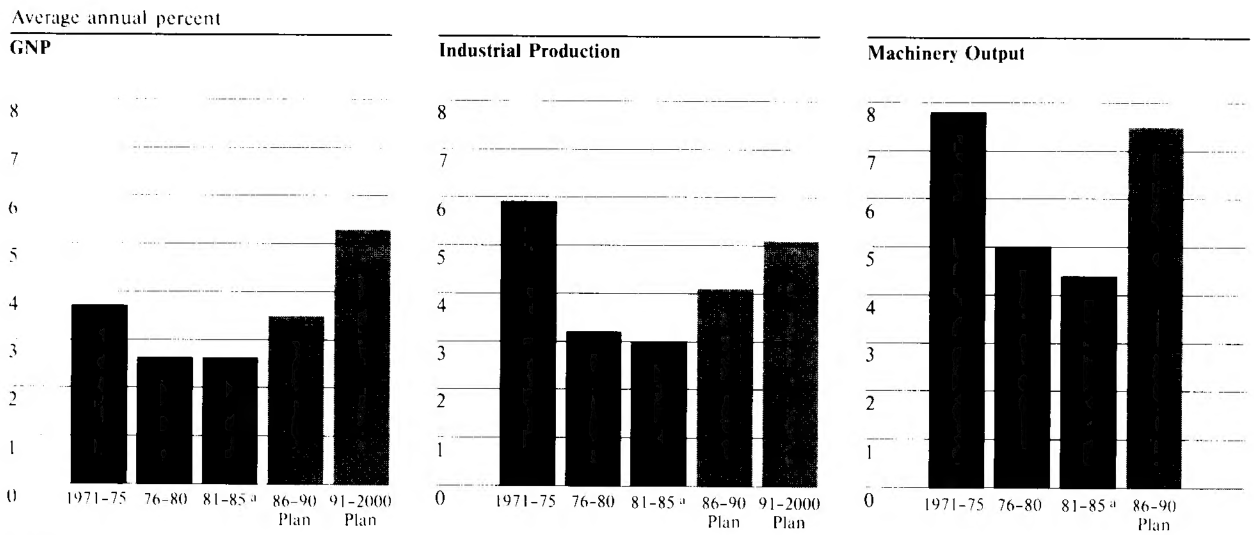
USSR: Selected Indicators of Economic Performance, 1971-2000



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to meet the unique needs of plants being retooled—a most difficult task for an industry used to manufacturing large lots of a small variety of equipment for use in plants being constructed under highly standardized designs.

- The bureaucratic and geographic separation of research from the production line will continue to slow the development and introduction of new equipment. *Pravda* reports that 70 percent of all inventions get no further than the prototype stage and only 2 percent are ever introduced into five or more enterprises.

- Shortages of critical components will impede the development of high-technology machinery.

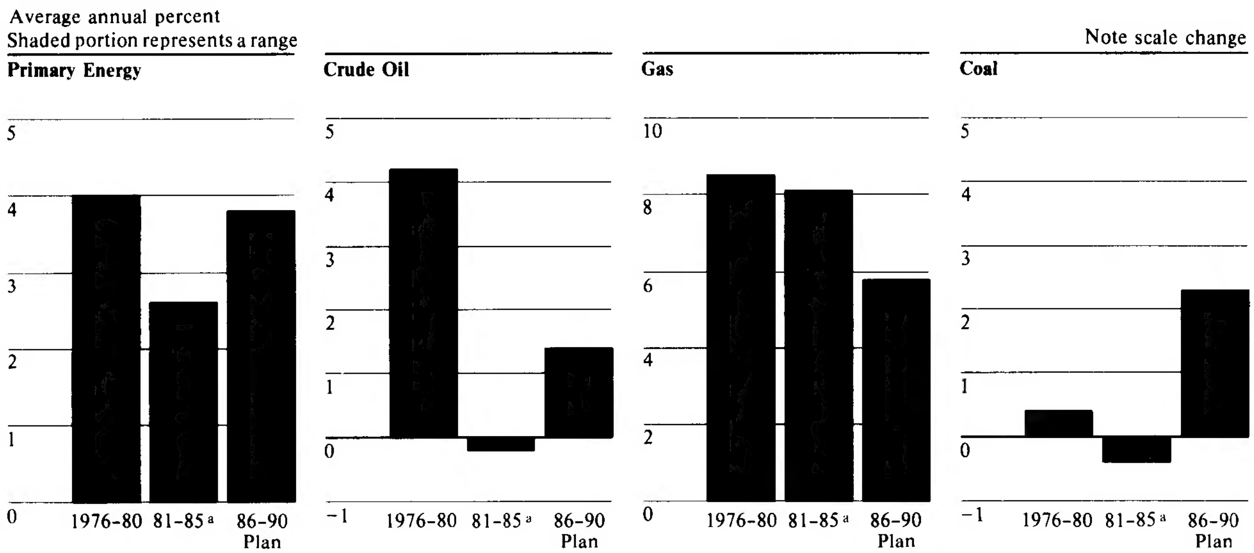
The plan makes clear that Moscow expects its domestic machine builders to receive substantial help from Eastern Europe. The plan guidelines reflect the regime's determination to increase economic integration within CEMA by emphasizing direct production links between enterprises and the implementation of joint large-scale projects. The recent appointment of Boris Aristov and Nikolay Talyzin—both with extensive experience in East European affairs—as Foreign Trade Minister and Chairman of the State Planning Committee, respectively, could facilitate this effort. 25X1

Energy—A Major Stumblingblock to Plan Fulfillment

Moscow will clearly have trouble achieving its goal of 3.2- to 3.8-percent average annual growth in energy production. Although the targets for gas and electricity production appear attainable, those for oil and coal are probably beyond reach: 25X1

- Coal output, after five years of stagnation, is to increase by 10 percent by 1990—with the entire increment made possible by productivity gains.

USSR: Average Annual Energy Production Growth, 1976-90



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Coal production at most major underground mines is in decline, however, and output and use of the lower grade coal found in surface mines continues to be costly and beset with technical problems.

- Oil production is supposed to rise sharply, reversing a two-year decline. In view of the decreasing well flows in West Siberia and the aging of the USSR's best fields, however, we expect the decline to continue.

Shortfalls in oil and coal production will likely limit increases in total energy output to about 2 percent annually, thus threatening new economic bottlenecks.

Big Promises to the Consumer

Agricultural output is to rise by 3.2 percent annually—nearly 1 percentage point more than the 1981-85 average—with all growth coming from increased productivity. By 1990, the size of the grain harvest is to increase by about 30 percent over the level of recent years. Even with the scheduled increases in deliveries of critical inputs, such as fertilizer and machinery, these targets are probably out of reach unless weather conditions return to the average for 1976-80—the most favorable of the past 65 years. In consumer goods other than food, the 2.6-percent growth achieved during the period 1981-85 is to be doubled. This goal is unlikely to be achieved without substantial increases in investment, but a high-level Soviet planning official indicated earlier to our Embassy that there will be little, if any, increase in investment for the consumer. 25X1

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Resource Allocation in Question

Overall investment in 1986-90 is to rise at about the same rate as GNP, but the draft guidelines give no indication of how capital resources will be

allocated among sectors. The plan for 1986, just published last week, calls surprisingly for a big hike in investment—to almost 8 percent—implying that to stay within the 12th Five-Year Plan guidelines, investment growth would have to fall to about 2.5 to 3 percent per annum during 1987-90. The big push in investment in 1986 indicates Gorbachev's intention to get his industrial modernization program off to a running start. Priority will go to machine building—the sector most critical to modernization—but energy will get a sharp boost as well. If investment growth stays within the 1986-90 guidelines—and machine building and energy maintain their increased shares planned for 1986—other critical sectors such as transportation are likely to be squeezed. [redacted] 25X1

Prospects

The productivity increases called for in the 1986-90 plan are far greater than any achieved in recent years. While some improvement is possible from increased discipline and better management, substantial gains require a quick payback from Gorbachev's industrial modernization campaign. But the lead times involved in producing new, productivity-enhancing equipment are long, and Soviet machine builders—given their track record—may not be up to the task. In any event, few benefits would be realized over the next five years. On balance, the plan's stress on unrealistic gains in productivity is likely to result in production shortfalls, increased bottlenecks, and unfulfilled expectations. [redacted] 25X1

[redacted] 25X1

Mexico: Dim Prospects for Economic Reform [redacted] 25X1

Mexico is rapidly losing its reputation as the model debtor because of government failures to take appropriate adjustment measures and the subsequent economic problems that currently beset the country. In our opinion, the key question for Mexico's economic future is whether President de la Madrid is able and willing to return to implementing strong macroeconomic adjustment policies and complement those with difficult, long-term economic structural reforms. The 1986 budget—although viewed as overly ambitious and unrealistic—represents short-term movement in the right direction. We believe, however, that implementing this budget likely will exhaust much of the President's political clout, damaging prospects for more substantial reforms. Until a comprehensive policy package can be put in place, we believe Mexico will continue to incur budget overruns, current account deficits, and financing gaps that will reduce the President's policy options. [redacted]

Initial Success Shortlived

During 1983 and 1984, Mexico's economic adjustment policies and their implementation under de la Madrid were cited by the international financial community as the model for other debtor countries. As Mexico's financial troubles eased, the deep recession created by these stringent policies caused the government to reassess its economic situation in mid-1984 with an eye toward political gain. We believe the shift in policy direction that occurred reflected both the ruling party's (PRI) belief that Mexicans would not accept continued strict austerity and the view that it was necessary to make a strong showing in the important July 1985 local and gubernatorial elections. According to Embassy reports, key government officials decided a greater level of economic growth was necessary, even at the cost of higher inflation and overvaluation of the peso. High government spending, along with an accommodating monetary policy, spurred domestic demand and boosted real GDP in the first six months of 1985 at a 6-percent annual rate. Mainly as a result of these excesses, Mexico is now experiencing serious financial and economic problems that were complicated by the recent earthquake:

- Nearly $14 billion in budget overruns this year are being financed largely through domestic borrowing.

- The money supply has risen by 65 percent so far this year, according to Embassy reporting, fueling an annualized inflation rate of at least 60 percent. Recent efforts to force interest rates down have nearly halted private purchases of government bonds and threaten to fuel money supply growth.

- [redacted] capital flight is continuing at about $1 billion per month. This outflow has put renewed downward pressure on the peso as the free market rate has fallen from 360 per US dollar in mid-August to over 500 per dollar by late November [redacted] 25X1 25X1 25X1 25X1

- Mexico's current account has moved into deficit and the financing gap has widened. We believe in 1986 Mexico will need perhaps as much as twice the $4.1 billion in foreign funding already requested from international creditor institutions. [redacted] 25X1

The government's commitment to a new set of austerity measures, announced shortly after the elections was sidetracked by September's earthquakes. Perhaps more important, de la Madrid's handling of the disaster caused latent doubts to

surface among supporters inside and outside the government over his leadership ability, [redacted]

Policy Challenges in 1986

In our view, de la Madrid will face a complex economic challenge in 1986—trying to avoid a repeat of 1983's deep recession and resisting political pressure to continue expansion. On the basis of his annual budget message delivered to the Mexican Congress on 15 November, it appears de la Madrid is aware of the difficulty. Allowing for little or no economic growth, next year's program seeks to slash the budget deficit as a percentage of GDP in half to 5 percent and cut inflation from over 60 percent to 45 percent. The President also promised significant structural adjustments and reaffirmed the country's intention to honor its debt obligations. [redacted]

We believe de la Madrid will come under increasing pressure to abandon austerity in the months ahead. Labor probably will try to recoup some of the 30-percent decline in real wages suffered over the last three years. Businessmen are likely to demand compensation if their profits are threatened by increased foreign competition. Moreover, political infighting within the President's economic cabinet threatens to undermine the confidence de la Madrid must build if he is to gain popular support, stem capital flight, and temper inflationary expectations. [redacted]

Longer term structural changes needed to restore market forces, encourage domestic savings and investment, and reverse capital flight include:

- Reducing the government's role in the economy, especially by the liquidation or sale of inefficient public enterprises and return of Mexico's banks to private-sector control.
- Redirecting public-sector investment to emphasize labor-intensive activities such as assembly industries, infrastructure construction, and agriculture.
- Liberalizing trade to promote competition through elimination of burdensome import licenses and bureaucratic redtape.
- Encouraging export promotion in the private sector to diversify sources of foreign exchange and reduce vulnerability to volatile oil prices.
- Changing foreign investment laws to acquire much-needed capital, create jobs, and modernize Mexican industry. [redacted]

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Dismal Prospects for Comprehensive Economic Restructuring

We believe prospects for implementation of longer term structural reforms are not good, because they all run counter to traditional Mexican political and economic philosophy and would have a painful impact on important interest groups. Government involvement in the economy is deep seated with many Mexicans regarding a strong government role and Mexicanization as a cornerstone of the PRI. Private-sector autonomy has been sacrificed to coopt groups such as labor and the left. The government, in turn, compensates affected influential businessmen by granting them favorable treatment, such as protecting their markets and appointing them to top positions in state-owned enterprises. [redacted]

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At the same time, we believe strong Mexican nationalism and a longheld policy of import substitution hinders Mexican policymakers from significantly opening the economy to foreign investment and imports. Despite the decision to allow IBM 100-percent ownership of its Mexican subsidiary—an exception to the standing 49-percent limit—we agree with international financial observers that the move was a one-time action designed to deflect foreign criticism. Import liberalization is viewed

with even greater trepidation by inefficient domestic producers who fear that foreign competition would threaten their entrenched monopolistic positions. Replacement of some licenses with a more efficient tariff system has helped boost imports by 30 percent this year. Since Mexico City would undoubtedly be pressured to compensate manufacturers for profits lost to foreign suppliers—at least in the short run—in our opinion, de la Madrid is not likely to make progress on this front. [redacted] 25X1

Because the adjustment measures required for long-term economic health would generate powerful controversy, we believe de la Madrid will muddle through with stop-and-go policies until his administration ends in 1988. Procrastination will leave the economy in worse shape than when he took office and make the inevitable adjustment more painful. From a political perspective, we believe this backsliding would aggravate existing policy conflicts within the government, strengthening the hand of those who favor anti-US and protectionist policies. [redacted] 25X1

[redacted] 25X1

Iran: Developing Alternative Oil Export Facilities [redacted] 25X1

Khark Island handles nearly 90 percent of all Iran's crude exports. Recent Iraqi success—although limited—at disrupting Iranian oil flows from Khark Island has forced the oil industry managers in Tehran to reexamine alternative oil export plans to bypass Khark. [redacted] a number of alternative export facilities—many still within Iraqi air range—have been discussed within Iran's National Oil Company (NIOC). All involve laying of pipe and the construction of another loading terminal. NIOC has already started construction of one at Ganaveh, and, we believe, construction of at least one more bypass project will begin soon, reducing Iran's dependency on Khark. Additional Iranian export facilities will also enhance the security of Western oil supplies and reduce the risk of escalation of the war within the Persian Gulf. [redacted]

[redacted]

Ganaveh Project

A short-term project is under way connecting the oil pipeline manifold at Ganaveh, which links Iran's onshore oilfields to Khark Island, with a loading facility to be located about 24 kilometers offshore. [redacted] two 42-inch pipelines are being laid, and [redacted] they will terminate in water at least 25 meters deep—enough to handle very large crude carriers.

We expect the initial loading facilities will probably consist of three floating hoses at the end of each of the two pipelines from which supertankers can load up to 1.5 million b/d. Once single-point buoy moorings (SBM)—[redacted]—are installed, we believe loading rates could exceed 2 million b/d. We estimate the cost of this project will be about $70 million with exports beginning in early 1986. [redacted]

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The IGAT2 Option

[redacted] one proposal under consideration involves laying pipe approximately 80 kilometers from the major Gachsaran oilfield across the mountains to the partially completed 56-inch IGAT2 gas pipeline—originally designed to transport gas from Iran's southern gasfields to the USSR. Plans to use the IGAT2 pipeline for gas transmission would have to be abandoned—a likely prospect given the continuing chill in Iranian relations with Moscow. The gasline would need to be converted to handle oil by adding a pump station along the line. Additionally, some modifications within the oilfield pipeline system would have to be made so that crude from Iran's other major oilfields could flow through this line to meet its projected capacity. The existing line ends at the Kangan gas processing plant in southern Iran, requiring NIOC to build a 30-kilometer connecting pipeline from the processing plant to an oil-loading terminal on the coast, probably at Taheri. We estimate that Tehran also would need to construct a tank farm to handle 6-10 million barrels of storage and install several SBMs to load the crude. [redacted]

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Our engineering analysis suggests this alternative could add approximately 2 million b/d to Iran's oil export capacity at a cost between $300-400 million

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and would probably take eight to 10 months to complete. The timeframe could be cut by up to half—but only at a proportional increase in cost by using additional crews and an intense work schedule. Crude flows through the IGAT2 line would be extremely difficult to disrupt because the pipeline would traverse inland mountain valleys and the proposed export facilities at Taheri would be much smaller and about twice as far from Iraq as Khark Island. [redacted]

Completion of IGAT2 as an oil project would also provide Tehran an option to continue the pipeline network from Kangan or Taheri to a point outside of the Strait of Hormuz, probably Jask, should an even more secure outlet be desired. The need for a crude oil pipeline—even two—to an export terminal outside the Strait has been seriously considered by both NIOC and the Iranian parliament before, but so far the high cost and long leadtimes of a new pipeline system have been considered prohibitive. Using the prospective IGAT2 connection, we estimate the overall project from Gachsaran to Jask would still involve the construction of several pump stations, more than 600 kilometers of pipeline, and a new oil storage and export terminal. Such a project could cost well over $2 billion and take two years or more to complete once an agreement is reached. [redacted]

The Pars Option

[redacted] Tehran is also considering use of another future gas project—the Pars project—as an alternate oil route. This project was initially designed—but never built—to bring gas north from the offshore Pars and onshore Kangan gasfields along the coast to the major onshore oilfields for injection to maintain oil reservoir pressures. The plan consists of laying two 42-inch high-pressure pipelines that would terminate at a loading terminal at Taheri, Asaluyeh, or Lavan Island. When the war is over, these lines could be converted back for use as a high-pressure gas transmission line. The option would provide a capacity of 2 million b/d, take up to two years to complete, and could cost in excess of $2 billion. [redacted]

Outlook

We expect that the IGAT2 oil pipeline project will be approved and would be started as soon as bids are reviewed and a contract agreement reached. The Pars gas pipeline conversion scheme will not be implemented, in our opinion, although the original concept for the Pars gas pipeline project may be approved. [redacted] 25X1 the productive capacity of Iran's main oilfields is deteriorating because of low reservoir pressures and must soon have gas injection to sustain current production levels. [redacted] 25X1 25X1

If Tehran proceeds with these projects, its export capacity will quickly exceed its oilfield productive capability—currently estimated at just over 3 million b/d. With repairs at Khark Island continuing, export capacity there could soon be nearly 4 million b/d and completion of the offshore facilities at Gavaneh would bring export capacity up to about 6 million b/d. By the end of 1986, Tehran could have an export capability of up to 8 million b/d if it proceeds promptly with the IGAT2 option and Iraq does not knock out the current export facilities. 25X1 Completion of these projects would give Tehran the ability to increase its oil exports well beyond current levels. [redacted] 25X1

With little prospect for any substantial increase in the demand for OPEC oil, higher oil exports by Iran certainly would add to downward pressures on world oil prices. 25X1 We would expect Tehran to try to maintain revenue flows so it can continue to finance its war, adjusting export levels and prices to accomplish its goal. Creation of additional Iranian oil export capacity will reduce the vulnerability of Tehran's oil exports to Iraqi attacks and the risk that Tehran might retaliate for attacks on Khark by striking Arab oil facilities across the Gulf. The West may also benefit from lower prices for crude as Iran competes with the other OPEC countries with surplus productive capacity to maintain revenues in a soft oil market, although we do not expect Tehran to be a leader in any oil-market price cuts. [redacted] 25X1

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Iranian Oil Export Alternatives

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Eastern Europe: Winter Energy Worries

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After suffering some of the worst energy shortages in the postwar era last winter, East Europeans are preparing anxiously for the coming season. Every country in the region is attempting to increase fuel production and imports, accelerate the repair and construction of energy facilities, and implement stringent—if belated—conservation measures. Nonetheless, Bulgaria, Romania, and Yugoslavia probably will incur energy shortages this winter even if the weather is average. These shortfalls will again cripple industrial production and stunt economic growth. The populace—especially in Romania—almost certainly will have to cope with another cold, dark winter that can only lead to further disaffection toward their Communist leaders.

Last Winter's Big Chill

Temperatures in Eastern Europe last January and February averaged 9 degrees Fahrenheit below normal. The cold weather increased demand for energy and disrupted supplies, hindering transportation and industrial production. The impact of the energy shortages varied considerably, with countries in the southern tier faring worst:

- In ***Bulgaria,*** widespread shortages of electricity and heating created a near emergency. Electricity was provided on a three-hours-on, three-hours-off schedule. The few open gas stations faced long lines of motorists. Factories were shut down, train schedules were reduced, television broadcasts were scaled back, and school classes were canceled to conserve energy.

- In ***Romania,*** authorities implemented strict measures to ration energy. Additional workers were mustered for round-the-clock mining operations to increase coal production. A 50-percent reduction in public lighting was mandated, with households limited to the use of one 15-watt light bulb. Across the country many homes were without heat, gas, or water for days.

- In ***Yugoslavia,*** heavy snows disrupted coal and fuel oil deliveries to thermoelectric plants causing brief power outages in some areas. The government was forced to boost imports of oil by 31 percent and to increase imports of electricity. Deliveries of gas to industry were restricted, and some towns experienced heating problems. 25X1

Drought—now in its third year—aggravated energy shortages in these three countries, which depend more than the rest of the region on hydroelectric power. Yugoslavia is the most vulnerable because it relies on hydroelectric power for one-third of its electricity compared to 14 to 18 percent in Romania, and 8 to 12 percent in Bulgaria. 25X1

Although countries in the north fared better, energy shortages there also were worse than usual: 25X1

- In ***East Germany,*** authorities called in military personnel and police to help mine and transport coal and operate power stations when the freezing of water-laden lignite beds caused local fuel shortages and power outages. East Berlin was forced to import coal from West Germany to keep steel mills from shutting down.

- In ***Czechoslovakia,*** deliveries of gas to large-scale industrial consumers were cut 10 percent. Coal deliveries were down because the Elbe River froze and rail transportation fell below planned levels.

- In ***Hungary,*** a natural gas shortage forced restrictions on industrial users for more than 40 days, resulting in considerable loss in production. Although imports of oil and natural gas were increased for industry, most consumption needs were met by oil reserves, according to the Hungarian press. Households, however, were largely unaffected except for restrictions on TV broadcasting, sporadic electricity shortages, and some rationing of coal.

Constraints on Energy Imports

A shortage of hard currency and tight Soviet oil supplies contribute to Eastern Europe's energy worries. The hard currency problems, which plagued most of Eastern Europe in the early 1980s, have forced the region to restrict Western imports, slowing the replacement of antiquated plant and machinery with more modern, energy-efficient equipment. The poor condition of power installations results in frequent breakdowns and limits the ability of these countries to step up energy output when demand surges. Moreover, most countries cannot afford to buy substantial amounts of additional oil in the West.

Although Soviet energy deliveries to several countries were interrupted temporarily last winter because of technical and logistic problems, Moscow for the most part met the contracted volume of deliveries. Limits on Soviet oil deliveries in recent years, however, have forced Eastern Europe to rely more heavily on domestic resources. Thus, last winter's disruptions in production hit even harder. Moreover, because of its displeasure with Sofia's economic and political policies, Moscow has decided to cut oil supplies to Bulgaria and made it clear that other East European countries cannot expect increased deliveries in the coming years.

- In ***Poland,*** supplies of coal, natural gas, and electricity to large industrial users were restricted to make extra energy available to heating plants, power plants, and households. Transportation breakdowns because of heavy snow and freezing temperatures hampered coal deliveries. Sporadic shortages hit many areas around the country.

Difficulties Continue

While the energy situation eased in the spring, Bulgaria and Romania have continued to be plagued by shortages. In late July, Bulgarian authorities reinstituted the three-hours-on, three-hours-off electricity schedules, and in August moved to a two-hours-on, two-hours-off schedule for most of the country. A Bulgarian official admitted to US diplomats in late October that 10 percent of electrical capacity was shut off at any given time. Romania's energy difficulties were highlighted in October when the government announced that military commanders were to be assigned to all power plants to oversee the strict observance of maintenance and production schedules. Employees are to work under stringent military rules. 25X1

Continuing problems in Yugoslavia were evidenced in October with the imposition of restrictions on electricity usage throughout much of the country. The restrictions, while generally mild, have created anxieties over the coming winter. Some republics have already begun to cut electricity to industry.

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Outlook

To avoid a repetition of last winter's shortages, the East Europeans are attempting—with limited success—to expand energy production and replenish stocks. They are also speeding repair work, constructing new energy facilities, and imposing various conservation measures. Hungary, Bulgaria, Poland, and Yugoslavia also have raised prices for domestic energy in order to dampen demand. Planned outages in Romania and Bulgaria are largely attempts to spread energy reductions throughout the entire year and avoid more serious disruptions during the winter. 25X1

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We believe that the northern tier of the region will make it through this winter without major energy disruptions, barring another bout with record cold. For Czechoslovakia, Hungary, Poland, and East Germany, their ability to meet most of their energy needs under adverse conditions, combined with extra precautions and better overall preparedness, suggests that an average winter will pose no major threat. 25X1

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Yugoslavia's prospects this winter hinge in large part on the continuing severity of the drought. At this point the situation potentially is more serious than last year, but better than in 1983 when reduced hydroelectric reserves—as much as 40 percent below normal—led to periodic electricity blackouts throughout the country.

Bulgarians probably will suffer the same electricity cutbacks this winter that they have faced most of this year despite measures to increase supplies and remedy the breakdowns in the power industry. While Sofia's planners could increase imports even more to offset production shortfalls and reduced Soviet oil supplies, they have been reluctant to increase hard currency debts and probably will continue to squeeze the population. 25X1

We expect that Romania will face the gravest energy difficulties this winter. The imposition of a military work regime on demoralized workers may succeed in lifting energy production somewhat, but coal production will fall far short of the unrealistic targets set by Bucharest. Because of acute hard currency problems, Romanian leaders will continue to export a significant portion of the country's oil—even in the face of domestic energy shortages. Romanian households will be forced to bear the burden of energy shortfalls. 25X1

Energy shortages this winter in Bulgaria, Romania, and possibly Yugoslavia will again be reflected in losses in production, which will lower economic growth and set back export and investment plans. Romania, trying hard to maintain some confidence of Western bankers in its crumbling economy, will have even more difficulty in sustaining hard currency exports. 25X1

Nonetheless, major domestic unrest due to energy shortages seems unlikely. Romanians are accustomed to hardships, and leaders in other East European countries were careful to favor households last winter at the expense of industry and subsequent production declines. We believe that Yugoslavia will monitor carefully popular reaction 25X1
to conservation measures. In the event of widespread public unrest, Belgrade probably would boost energy supplies to the population, either by shorting industry or increasing imports. 25X1

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Venezuela: Modest Reforms in Foreign Direct Investment Policy [redacted]

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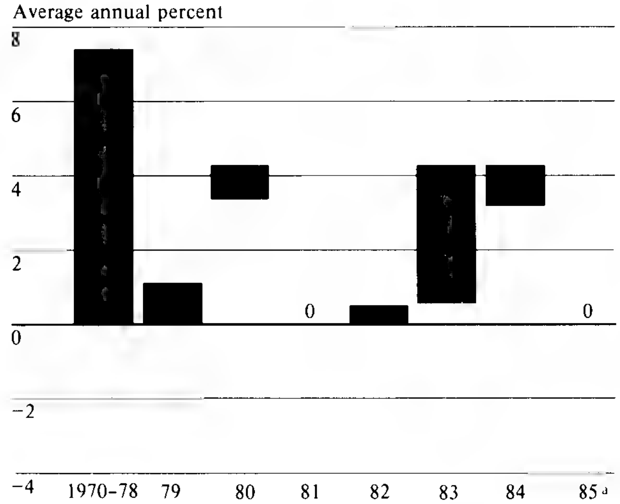
Confronted by the prospect of long-term stagnation in oil revenues, Venezuela has revised its development strategy. A key feature is a renewed role for foreign direct investment (FDI), to broaden the industrial base and reduce import needs. President Lusinchi's top economic advisers see FDI as an important potential source of technology, managerial know-how, and capital. The administration's attempts to liberalize regulations governing FDI, however, have been constrained by domestic political considerations and restrictions imposed by the Andean Pact. The reforms announced by the government last June are, in the view of the US Embassy, unlikely to stimulate significant foreign investment. We believe that, for the medium term, the absence of important new commitments by foreign investors will probably combine with depressed private domestic investment to further extend an economic recession that is now in its seventh year. Over the longer term, the failure to attract FDI raises questions about the prospects for economic development because of the state's reputation for inefficiency and corruption. [redacted]

Venezuela: Real Nonpetroleum GDP Growth, 1970-85



[a] Projected.

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[redacted]

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FDI: A Decade of Neglect

Venezuela withdrew the welcome mat for foreign investors in 1974, as euphoria over a prospective oil bonanza led nationalists to conclude that FDI was no longer essential. They asserted that the nation's capital requirements could be drawn from—or borrowed against—the inflow of petrodollars and that the technology that normally accompanies foreign investment could be licensed. Acceptance of this view led Venezuela to join the Andean Pact [1] in 1973 and, the following year, to enact legislation implementing the Pact's Decision 24, which regulates FDI. [redacted]

[1] The Andean Pact is an association for regional economic integration and cooperation comprising Venezuela, Colombia, Ecuador, Bolivia, and Peru. [redacted]

Venezuelan regulations implementing Decision 24 require that firms with majority foreign ownership:
- Convert to majority Venezuelan ownership within 15 years of entry.
- Limit annual profit remittances to 20 percent of registered foreign capital.
- Limit increases in registered foreign capital to 7 percent per year.
- Limit borrowing in domestic financial markets to an amount equal to 40 percent of capital.
- Negotiate royalty and license fees to be paid abroad with the office of foreign investment (SIEX). 25X1
- Submit to a bewildering array of SIEX rules and regulations. [redacted] 25X1

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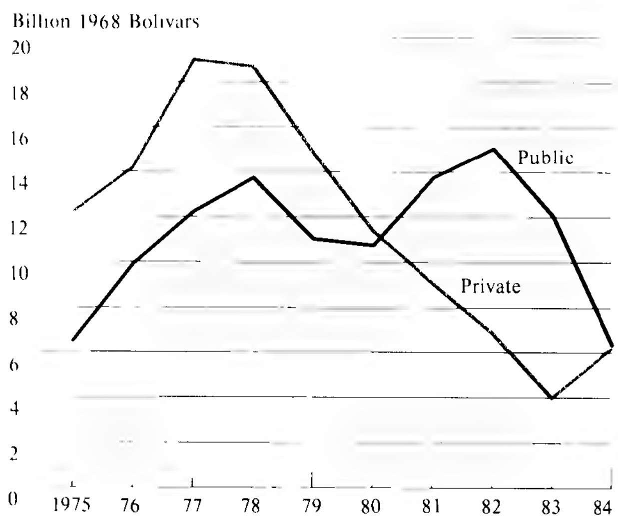
Venezuela: Gross Fixed Investment, by Sector, 1975-84



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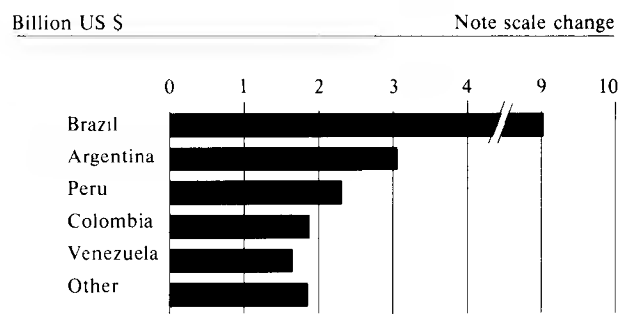
US Direct Investment Position in South America, 1983



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The results over the past decade have been dramatic—most registered foreign investment now in Venezuela entered before 1974. Since then, FDI has largely been financed through the reinvestment of retained profits, while investment financed by new money from abroad has slowed to a trickle. Investment consultants in Caracas note that potential investors object most to the requirement to convert to majority Venezuelan ownership. They add that fear of losing control of proprietary information causes some multinationals to reject even minority participation by host country investors.

The Politics of Reform

Last June, following nearly one year of intense debate, the President decreed a revision of the foreign investment code. According to the US Embassy, the move to liberalize the code was spearheaded by Development Minister Hurtado, Finance Minister Azpurua, and Minister of the Presidency Lauria—each a respected technocrat, but without power bases within the ruling party.

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According to press accounts, the reformers contended that the development strategy followed over the past decade had contributed to stagnation by making the economy overly dependent on the state for entrepreneurship, risk capital, and technology. Proponents also argued that, although the direct impact of increased foreign investment would be important, FDI's catalytic effect on domestic investors would likely be far more significant. Investment by foreigners would create opportunities for domestic investors in related industries and, by improving the general investment climate, would also encourage the repatriation of capital from dollar accounts abroad.

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The call for reform drew wide-ranging opposition, however. According to the US Embassy, leftist and nationalistic elements within the ruling party, as well as opposition parties of the left, rejected FDI liberalization on ideological grounds. In addition, domestic industrialists opposed any moves that might threaten their market shares and profits.

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Venezuela: Share of Cumulative Foreign Direct Investment, by Country of Origin, 1984 *Percent*

Total	**100.0**
Belgium	1.8
Canada	5.7
France	1.4
Japan	3.2
Panama	6.0
Switzerland	6.0
United Kingdom	7.8
United States	52.8
Others	15.3

Venezuela: Share of Cumulative Foreign Direct Investment, by Sector, 1984 *Percent*

Total	**100.0**
Agriculture, fishing, mining	2.4
Manufacturing	74.0
Electricity, gas, water	4.5
Construction	3.1
Commerce, restaurants, hotels, services	4.8
Transportation, communications	1.0
Finance, insurance, real estate	10.2

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Complicating President Lusinchi's dilemma, according to investment consultants in Caracas, was his fear of being perceived as caving in to foreign interests. He had been subjected to such charges when, shortly after taking office in 1984, he established a preferential exchange rate for repayment of the external private debt. Consequently, the June decree incorporates many of the changes advanced by the cabinet reform group, but also attempts to placate opponents by not carrying reform beyond the spirit of Decision 24.

The principal features of the reform are:

- Foreign investment may now be registered in the currency of origin, thus shielding the 20-percent cap on profit remittances against devaluations.
- Agriculture, agro-industry, tourism, and construction are exempted from the principal provisions of Decision 24.
- Investment in most other sectors may be approved if it emphasizes technology transfer, employment, local value added, or exports.
- The hard currency debt of foreign-owned firms may be converted to registered investment.
- Foreign-owned firms will be allowed greater administrative freedom from SIEX.

Dim Prospects

We believe that the June revisions are far too modest to generate a significant surge in foreign direct investment, despite ambitious forays abroad by SIEX to sell Venezuela to potential investors. The decree fails to address the core concerns of investors, in particular the requirement to convert to majority Venezuelan ownership within 15 years. A significant liberalization of Decision 24 will probably be required before investors again perceive Venezuela and the other Andean nations as attractive markets in which to invest. Andean Pact foreign ministers will meet in January to consider proposals for liberalization, a move that is gaining support within the Pact, according to reports from US Embassies. 25X1

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In our judgment, however, foreign investment flows are likely to remain depressed over the medium term, even if Decision 24 is liberalized. Investor confidence in Venezuela has been severely shaken by six years of economic stagnation, the deteriorating prospects for oil exports, a decade of policymaking flip-flops, and the Latin American debt crisis.

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Other countries with more positive foreign investment climates offer potential investors better profit prospects. [redacted] 25X1

Implications

To the extent that foreign investment—and associated domestic investment funds repatriated from abroad—falls short of its potential, balance-of-payments management will be more difficult than otherwise. This will, in our view, aggravate the pressures that stagnant oil revenues are likely to place on the government to limit current account deficits through austerity measures. [redacted] 25X1

The failure to attract significant foreign and associated domestic private investment also implies, we believe, continued reliance upon the state for entrepreneurship and risk capital. Such reliance could increase the potential for social unrest by retarding economic development. Over the past decade, the government has squandered huge sums of oil revenues on poorly conceived and ill-managed projects, and its management of investment funds has been riddled with corruption. [redacted] 25X1

For the United States, an improved investment climate would enable US firms to invest and produce behind Venezuela's heightened import barriers, thus offsetting, in part, US export revenues lost to such barriers. Nonetheless, we believe that continued restrictions on foreign direct investment clearly foreshadow reduced commercial opportunities in Venezuela, our most important export market in South America. [redacted] 25X1

[redacted] 25X1

Kenya: Economy at the Crossroads

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Kenya faces problems—a ponderous government bureaucracy, runaway population growth, deteriorating foreign payments position, and a vulnerable export market—which, if unresolved, could undermine its position as one of the few open and successful economies on the continent. After Kenya's remarkable economic successes in the first decade following independence in 1963, a series of international events, together with significant structural problems, have combined since the 1970s to undermine prior gains. In our view, Kenya can no longer afford merely to continue making relatively minor adjustments to the policies that have served it well in the past. Economic performance over the past few years has been mixed, but the prospects for improvement over the near term under the current government strategy are not bright. Although real GDP is expected to grow by 4 percent in 1985, Kenya is saddled with an urban unemployment rate exceeding 12 percent, a debt service ratio of approximately 30 percent, and sufficient hard currency for less than three months of imports.

Agriculture: A Troubled Sector

Kenya's crucial agricultural sector is in deep trouble. Agriculture provides more than two-thirds of Kenya's exports and contributes a 30-percent share of GDP; about 85 percent of the country's population depends upon agriculture for its livelihood. Agricultural growth has slowed considerably, from a 4.6-percent per annum growth rate during the eight years following independence to an average of about 2.7 percent during 1972-79. Total output from the agricultural sector declined by 2.9 percent in 1984 compared to 1983, largely because of the worst drought in the country's history. Coffee, sisal, and sugarcane showed modest increases with most other agricultural commodities registering declines. The IMF estimates, that, in 1984, grain output fell by about 40 percent below normal levels, requiring Kenya to import large amounts of foodstuffs. The only bright spots were the doubling of the world-market price for tea and a 10-percent improvement in the export price for coffee in 1984 25X1

Although Kenya has emerged successfully from the drought in 1985, serious long-term problems remain. The relentless growth in population—the highest in the world at 4.2 percent last year—is outstripping the ability of farmers to increase food production. Kenya's small proportion of arable land has exceeded its carrying capacity, forcing growing numbers to cultivate marginal lands and making productivity gains more difficult to achieve. Kenya's agricultural productivity has been further eroded by disincentives to farmers resulting from government regulation of prices. According the US Embassy, actual receipts by Kenyan farmers are generally between 75 and 85 percent of the free-market price. In spite of government promises to reduce the number of commodities that are price controlled, progress to date has been slow. 25X1

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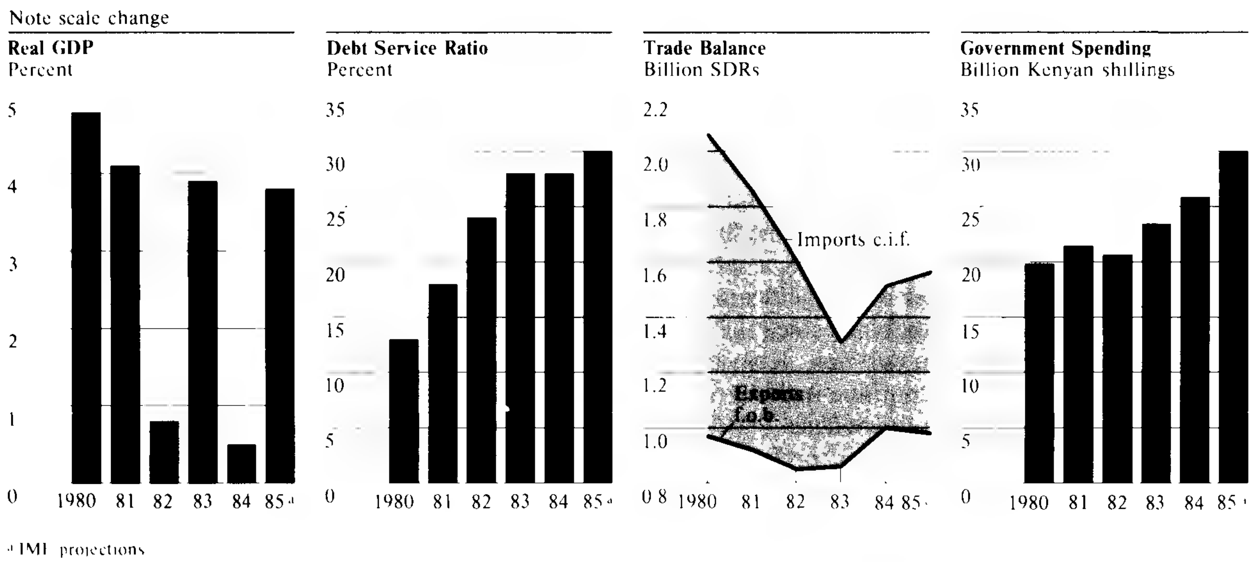
Sluggish Manufacturing Performance

Protectionism and import substitution of the post-independence years have not prepared Kenya's manufacturing sector for competition in current markets. Comprising approximately 11 percent of GDP, with a growth rate of about 4 percent in 1984, Kenyan industrial output has slowed considerably compared to the 10-percent average growth rate of the 1970s. The collapse of the East African Community in 1978, with the ensuing closure of neighboring countries' borders, and attempts by the government to open domestic markets to imports have hurt Kenyan manufacturers, increasing unutilized capacity and delaying additional investments. Kenya's declining terms of trade have considerably

Kenya: Selected Economic Indicators, 1980-85



[redacted]

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limited the country's import capacity and hence the supply of essential foreign inputs for industrial production.[redacted]

Inhibiting Role of the Public Sector

The government's role in the economy is overly intrusive and often counterproductive, in our judgment. Although government spending accounts for only about 29 percent of GDP, the government controls the prices of basic producer and consumer goods, bank rates, foreign exchange rates, and minimum wages. The US Embassy reports that the huge, inefficient, and costly Kenyan bureaucracy fetters the marketplace with overregulation and corruption, reducing incentives to investors and primary producers. Kenya operates a vast network of parastatal organizations—apart from the statutory boards, there are 47 wholly owned enterprises and more than 100 companies with majority or minority government ownership. While some of these public enterprises have made profits, many have made significant losses, with the cumulative effect of a net fiscal drain and the diversion of scarce resources away from more productive uses. Substantial progress has been recorded in reducing the overall budgetary deficit in the last few years, but, according to the IMF additional actions will be required in the 1985/86 budget.[redacted]

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Foreign Payments Difficulties

Kenya's vulnerability to fluctuations in commodity prices, combined with the recent drought, has generated a worsening foreign payments situation. Although Kenya benefited from unanticipated high coffee and tea prices in 1984, the outlook for 1985 and 1986 is precarious. A combination of high import levels, less buoyant coffee and tea earnings, "off-budget" foreign exchange commitments for

airline and patrol boat programs, plus a slower rate of disbursal from aid donors will reduce foreign exchange holdings. Kenya's central bank and treasury project a 20-percent fall in coffee prices and a 34-percent drop in tea prices this year. Coffee earnings will remain further constrained by Kenya's modest International Coffee Organization export quota which stands at two-thirds of its production.

As a result of reduced coffee and tea prices, the Kenyans have boosted their projection of the current account deficit for 1985 by 25 percent. According to internal central bank estimates, at the end of October, Kenya's foreign exchange reserves stood at $320 million—the lowest level in two years—enough to cover less than three months of imports. Thus far, there has been no increase in government grants from donors. Likewise, tourism earnings are not expected to improve unless there is a new appreciation of the US dollar. Unless Kenya's export sector improves drastically, the next several years will be difficult.

IMF Gains

Kenya's implementation of many IMF recommended adjustments and its integration of the private sector into its development strategy stand in stark contrast to the policies of most of its radical African sister states. Having successfully negotiated several standby agreements, Kenya stands as one of the IMF's prize pupils in Africa. Despite the trauma of the 1984 drought, Kenya has effected some limited IMF-sponsored adjustments that have merely kept the lid on the budget deficit and inflation—currently about 12 percent. Under the Fund's auspices, Kenya has made strides in liberalizing the trade regime, slowing fiscal expansion, depreciating the Kenyan shilling, and enacting several other reforms laudable in an LDC context.

According to the US Embassy, however, some observers feel that the IMF is pulling its punches on more fundamental reforms for fear of damaging its present positive relationship with Nairobi. We believe the generally optimistic outlook held by the IMF has served both to postpone needed policy adjustments and to limit the bilateral aid that a more pessimistic assessment of Kenya's economic health would elicit from donor countries. 25X1

Economic Outlook: Hard Choices

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The coming years will be crucial ones for Kenya's economy. The combination of several years of external shocks to the economy and lack of adequate policy responses have led to growing economic tensions. Although increased export prices helped to lessen the impact of the 1984 drought, Kenya, in our view, cannot reliably depend upon the volatile commodity market to raise domestic growth. Kenya's current abundant food situation masks a sharp deterioration in the terms of trade for its chief resources, coffee and tea. 25X1

Unless the Moi government can use its present window of opportunity before the next external shock to enact the arduous reforms necessary to encourage growth, we believe Kenya's past achievements will be undermined. In our view, prerequisites to better per capita growth performance include the dismantling of policies that retard agricultural growth, instituting aggressive budgetary and anticorruption measures, rationalizing parastatals, and reducing the rate of population growth. Unless decisive action is taken on these and other fronts, it is difficult to identify a vehicle that Kenya can use to generate sustained economic growth. 25X1

The Kenyan Government acknowledges the need to act on the host of hard choices to effect structural change. It wants the resources that are available from its bilateral and multilateral donors but finds the broad policy prescriptions that accompany the dialogue with donors unpalatable. We believe that the government's desire to limit the presence and influence of private corporations, the role of tribal patronage in Kenya's economic decision making, 25X1

and the general government desire to be in the driver's seat will limit President Moi's willingness to enact the major initiatives necessary to invigorate the economy. [redacted] 25X1

[redacted] 25X1

Briefs

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Energy

OPEC Ministers Meet This Weekend

The meeting in Geneva will probably focus on ways to avert a major break in oil prices early next year. Little progress is likely to be made, however, because oil companies are building up stocks for the winter heating season, which has strengthened the oil market and reduced the pressure on OPEC to take immediate action. OPEC crude oil production rose to about 18 million b/d last month in response to the higher demand, but this level probably would be about 3-4 million b/d greater than next spring's demand for OPEC crude oil. 25X1

[redacted]

Oil Price Increases

Several non-OPEC oil producers have announced crude oil price increases in response to rising spot prices. Egypt raised prices for its heavier crudes by 25 to 65 cents per barrel, and Mexico increased its light crude prices by 55 to 85 cents per barrel effective 1 December. In addition, two Canadian companies have announced increases of more than $1 per barrel. Meanwhile, Venezuela plans to raise prices for petroleum product exports. Spot prices are rising because of low oil inventories, the start of the winter heating season, and curtailed Soviet exports. Unless OPEC producers restore production discipline and cut output, however, the market will have a difficult time supporting these increases. Price weakness could reappear by early next year in response to a seasonal decline in demand or sooner if oil inventories begin to climb. [redacted] 25X1

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Reduction in Soviet Oil Exports

The Soviets are warning longtime customers in the West that contracts for delivery of crude oil and refined products next year will be reduced. Hard currency oil exports for 1985, estimated to average 1.15 million barrels per day, are down 25 percent from last year. [redacted] Apparently deliveries to the West will bear the brunt of any reductions, at least initially. The USSR's prospects for reversing the decline in its hard currency earnings are slim. So far Moscow has responded by stepping up borrowing and apparently by postponing purchases. It may, however, want to step up gold sales next year. [redacted] 25X1 25X1 25X1 25X1 25X1

Iranian Oil Barter Difficulties

Recent Iranian oil barter deals have encountered resistance that could worsen shortages of imported goods. [redacted] an increasing number of foreign customers have rejected Iranian barter proposals because of 25X1

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concern over Tehran's ability to export oil through the Gulf. Handling fees as high as 18 percent charged by "middleman" companies, and the recent slide of the dollar—which complicates calculations of these charges—also are cited by customers. In addition, many firms have complained about stringent technical clauses in the contracts and bureaucratic inefficiencies in Tehran. These difficulties are likely to cause Iran to channel trade through its well-established barter links to Japanese and Turkish firms. [redacted] 25X1

[redacted] 25X1

Iraqi Pipeline Negotiations

[redacted] 25X1

[redacted] 25X1

[redacted] according to the US Embassy in Riyadh, the negotiations for the second phase of the Iraqi-Saudi pipeline appear stalled after reportedly difficult meetings between the two countries' petroleum ministers in early November. Although a Saudi agreement in principle for phase two was obtained sometime ago, Iraq probably is resisting expensive Saudi technical requirements nominally intended to protect Aramco's colocated facilities. We believe Saudi reluctance stems more from concern about Iraqi access to Saudi Arabia and more Iraqi oil in a weak oil market. [redacted] 25X1

[redacted] 25X1

[redacted] 25X1

Meanwhile, Sanaa has asked the World Bank to help it establish a new mechanism to review all contracts and proposals from firms interested in a role in North Yemen's oil industry. This may stem from criticism by some officials that international firms took advantage of North Yemen's lack of experience in negotiating oil contracts. Sanaa's new system, however, is unlikely to affect the oil relationship with the United States. [redacted] 25X1

Movement on Sakhalin LNG Project Unlikely

[redacted]

As Foreign Minister Shevardnadze's January visit to Japan approaches, pressure to find a suitable welcoming "gift" is rising. [redacted] 25X1

[redacted] 25X1

[redacted] MITI may offer to import 1 million tons of LNG beginning in 1995 and somewhat larger quantities at an unspecified later date. This represents a five-year postponement and a two-thirds reduction in the 25X1

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original volume. MITI probably wants to stall as long as possible. The proposed cut in volume, however, would make the venture uneconomic,and, we believe, the project will remain on hold. Japanese utilities already have sufficient supplies well into the 1990s and want the Soviets to lower their price to below that of oil, which is unlikely. [redacted] 25X1

China Stalling on Nuclear Power Contracts

[redacted]

Beijing is deliberately stalling on finalizing contracts with West German and French firms for construction of nuclear power plants in China. Moreover, the bidding for these much-coveted deals may be reopened to include US and Japanese suppliers. (Both the US and Japan recently signed nuclear accords with China.) Beijing, over the last five years, has expressed dissatisfaction with the French over pricing terms and the slow projected rate of technology transfer for the Daya Bay project in Guangdong Province. Moreover, Chinese officials have stated that the current talks are France's "last chance." Beijing has also pressed the West Germans, the leading contender for the Sunan project in Jiangsu Province, for a sizable amount of countertrade financing. Although the Germans may be willing to cooperate, Beijing has not budgeted the project in the next five-year plan. Experiencing a significant foreign currency shortage, China may be prepared to temporarily forgo the nuclear option and turn to low-cost coal plants until economic conditions improve. 25X1

[redacted] 25X1

International Finance

Brazil Going It Alone

[redacted]

Brasilia currently feels little pressure to conclude new IMF and debt agreements because of its strong foreign payments position. Finance Minister Funaro announced last week that Brazil will cease efforts to reach an IMF accord and to restructure its bank debt. Brasilia claims its fiscal reform program for 1986 is as tough as is politically feasible and that it will reduce the public-sector deficit substantially, although not as much as demanded by the Fund. 25X1

[redacted] 25X1

The government 25X1 evidently believes that most banks will continue to reschedule short-term credits and principal repayments next year if interest payments are met. With important national elections scheduled for late next year, greater concessions to international creditors are likely only if the inflation rate exceeds 250 percent. [redacted] 25X1

Brazilian Private Bank Failures

[redacted]

The government's decision last month to liquidate two large private banks in Sao Paulo and a smaller bank in the south should strengthen the domestic financial sector but may further sour relations with foreign creditors. Financial difficulties have plagued the three banks for much of this year because of bad loans and poor management. Most other large private banks, however, generally are showing hefty profits, according to Brazil's financial press.

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Breaking with past policy of bailing out large troubled banks avoids boosting the large fiscal deficit. Many foreign bank creditors, however, are concerned about the unwillingness of the government to guarantee full repayment of the failed banks' overseas loans and maintain that rolling over short-term credits or restructuring debt must await resolution of the issue. [redacted] the National Monetary Council has not yet taken a final official stand [redacted]

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Egypt Attempts To Cut Supplier Credit Arrearages

[redacted]

Egypt's four public-sector banks have reportedly been instructed by the government to eliminate supplier credit arrearages by the end of the year. Arrearages that had been running as much as seven months behind have, according to US Embassy sources, been cut to four months. President Mubarak reportedly ordered the Central Bank to clear up arrearages after belatedly learning of Egypt's deteriorating credit rating. Many foreign banks have recently reacted by building in higher charges, cutting back on the length of credit, and reducing credit lines. Most of the banks are, however, apparently having difficulty obtaining the needed foreign exchange from the Central Bank. Cairo will probably settle for something less than total elimination of arrearages, given competing demands for scarce official exchange reserves. The current effort to reduce arrearages is widely rumored to presage a devaluation and exchange rate unification shortly after the beginning of the year. [redacted]

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Improved Portuguese Finances Prompt Loan Renegotiations

[redacted]

Portugal is trying to take advantage of its improved credit rating by seeking better terms on some outstanding loans. Since 1981, the country's current account deficit has been slashed 90 percent—to an estimated $250 million this year—while foreign exchange reserves have tripled to a reported $1.7 billion. Lisbon is trying to renegotiate the terms on two 1983 loans—totaling $550 million. The government would like to drop the US prime margins and to reduce the LIBOR margin by one-half percentage point. Despite some grumbling, the banks will probably agree. Portuguese officials hope this would enable them to refinance other loans and to negotiate improved terms on new credit. Portugal's impending EC entry is likely to mean a larger current account deficit and new external borrowing needs. [redacted]

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Zambia Lays Groundwork for IMF Standby

[redacted]

The success of Lusaka's weekly foreign exchange auction has removed a major obstacle to a new IMF standby loan. The IMF ended disbursements last January because of Lusaka's refusal to meet IMF devaluation guidelines and its inability to reduce arrearages to the IMF. Zambia's decision in October, however, to use a weekly auction to allocate foreign exchange has resulted in a 60-percent devaluation. Organized, regime-threatening opposition to the devaluation is not apparent despite widespread grumbling in the military and labor unions about steep price increases. Agreement on a new standby arrangement probably would require additional cuts in budget deficits and

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about $100 million in new loans to cover IMF arrearages, according to US Embassy reporting. Zambia may be able to raise some additional funding at a scheduled 17 December meeting in Paris of the World Bank Consultative Group on Zambia. [redacted] 25X1

Mali's Third Standby Agreement Approved

On 8 November the IMF approved Mali's third standby agreement—a $24 million loan—which Bamako will likely use to pay military and civil service salaries and amortize its previous standby agreements, according to the US Embassy. Negotiations, which were strained in early October over IMF suggestions of higher domestic cereal prices, were concluded after officials won union support for the agreement by promising a wage increase in 1986. 25X1 Nonetheless, the country's drought-ridden economy still faces structural problems that ensure domestic tension in coming months. [redacted] 25X1

Global and Regional Developments

Ottawa Renews Footwear Quotas

Ottawa's decision to extend quotas on women's and girls' footwear—they have been in effect eight years—provoked an angry reaction from the EC, heightening tensions between the two trading partners. Ottawa accepted the recommendation for extension by an independent tribunal to reassure the key provinces of Ontario and Quebec that it can safeguard their interests in the upcoming bilateral talks with Washington. Because women's and girls' footwear accounts for 60 percent of EC footwear exports to Canada, the Community is requesting immediate consultations with Ottawa on compensation under the GATT. The EC would prefer a negotiated settlement but is threatening retaliation; Canadian turbines, paper, and petrochemicals are likely targets. 25X1
[redacted] 25X1

[redacted] 25X1

Japanese Aggressively Selling Telecommunications Equipment to China

[redacted] Japanese suppliers will probably dominate the Chinese market for telephone switching equipment. China is expected to become the world's largest market for such equipment during the 1990s as it attempts to achieve its goal of increasing the number of telephone lines in service from the present 5.6 million to 33.6 million by the end of the century. Price advantages on sophisticated equipment and market penetration in 10 25X1

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major cities are key to Japanese success, [redacted] A Belgian subsidiary of a US telecommunications firm plans to triple the size of its joint venture with a Chinese producer as the only way to effectively compete with Japanese companies. Competition for the added sales will add greatly to Beijing's present minimal leverage over Japan in areas such as increasing imports of Chinese agricultural products and fuels and expanding technological cooperation. [redacted] 25X1 25X1

Soviet Purchases of US Agrotechnology

In mid-October the USSR agreed to purchase 714 metric tons of US herbicide, costing $50 million, which will broaden the spectrum of weeds controlled in Soviet grain and sugar beet fields. Negotiations are also under way to buy a 1,400 ton-per-year herbicide plant to be completed in five to six years. The Soviets continue to purchase large quantities of Western pesticides for their "intensive technology" program to boost crop yields. [redacted] some intensively cultivated fields yielded as much as one and a half to two times more grain than traditionally cultivated fields in 1985. [redacted] 25X1 25X1 25X1 25X1

[redacted]

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[redacted]

Libya Purchases Oil Refinery in Italy

Libya has purchased 70 percent of the outstanding stock of the financially troubled Tamoil oil refinery and distribution system, according to the Italian Ministry of Industry. The relatively unsophisticated refinery has a capacity of about 100,000 b/d. Libya's first acquisition of a foreign refinery increases Tripoli's overall refining capacity to nearly 500,000 b/d and provides a guaranteed market for a portion of Libyan oil. Rome is probably uneasy about the purchase, but prefers Libyan ownership to the loss of 450 Italian jobs if the refinery were to close. Several major companies have abandoned their refinery operations in Italy over the past few years because of government redtape and declining demand, and the government is anxious to avoid further job loss. 25X1
[redacted] 25X1

National Developments

Developed Countries

Japanese To Increase Imports of US Semiconductors

NEC, the largest Japanese semiconductor maker, reportedly has decided to import more US-made semiconductors next year in response to MITI guidance. [redacted] NEC officials expect that other 25X1
Japanese electronics firms also will increase such imports. NEC will purchase more bipolar devices for which US firms have been strong traditional suppliers but that NEC itself now could make in Japan. The Japanese firms and MITI apparently believe that the increased imports will ease trade friction and lessen efforts to restrict Japanese semiconductor exports to the crucial US market. 25X1
Japanese imports of US-made semiconductors should increase next year in any event as both the US and Japanese semiconductor markets recover from this year's downturn in sales. Nevertheless, the trade balance will remain strongly in Japan's favor, since the Japanese are stronger in the larger market sectors, such as 256k DRAMs. [redacted] 25X1

Minimum Prices for Japanese Semiconductor Exports

MITI officials do not expect the United States to drop its semiconductor trade actions in exchange for the Japanese proposal to set minimum prices for semiconductor exports to the United States, [redacted] 25X1
[redacted] MITI officials proposed the price floors to assist 25X1
some Japanese firms that have been hurt by the rapid decline in semiconductor prices as well as to defuse US trade complaints. We believe minimum prices may be difficult to enforce because of unauthorized exports of semiconductors sold in Japan below the floor price. [redacted] 25X1
[redacted] 25X1
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Italy Unlikely To Meet Monetary Targets

Italy will probably be unable to decelerate its money supply growth enough in the last quarter of the year for the Bank of Italy to meet its monetary targets for 1985, despite their upward revision last month. Although both the monetary base and M2 have been growing by over 14 percent on an annual ba-

sis, the new annual targets were only raised to 11 percent for the monetary base and 12 percent for M2, from an original 10 percent for each. The Bank of Italy's pursuit of a tight money policy from 1980 to 1984 helped halve the inflation rate. If the apparent relaxation of monetary policy this year continues, however, it will almost certainly derail the government's efforts to reduce inflation from the current rate of 8.6 percent to 6 percent for 1986 [redacted] 25X1

Parliamentary Committee Opposes British EMS Membership

Support for British entry into the European Monetary System (EMS) received a setback last month when a bipartisan House of Commons committee came out against membership. While not ruling out eventual entry, the committee reaffirmed Prime Minister Thatcher's position that the time is "not yet ripe." The committee's main argument is that the pound is already overvalued against the deutsche mark, and, if the current exchange rate were frozen, British trade competitiveness would worsen due to Britain's higher inflation rate—two-thirds of Britain's $12.8 billion trade deficit with the EC is with West Germany. 25X1 Some committee members also expressed concern that membership would subordinate British macroeconomic policy decisions to those of Bonn. The report did point out that joining EMS would reduce currency fluctuations, thus helping industry with future planning. British membership, while probably inevitable, is not likely in the near future. [redacted] 25X1

Israel's Consumer Prices Fall

Israel's consumer price index declined 1.5 percent in the first half of November, the first recorded drop in 11 years. Inflation for all of November is still expected to be positive, but under the government's 3-percent target. The rate for all of 1985 is likely to fall below 200 percent, compared with last year's record rate of 445 percent. Slowing inflation stems in part from the over 20-percent decline in real wages since the government imposed new austerity measures last July. 25X1 Demand is expected to be held in check in the near term as further cuts in government spending are being considered for the 1986-87 budget, and no new wage concessions are in the works. [redacted] 25X1

Less Developed Countries

Chile's Economic Problems

The government is worried that current economic policies and projected growth of less than 2 percent this year will aggravate unrest and further weaken President Pinochet politically, according to the US Embassy. Economic performance has been hurt by prolonged delays in negotiating a debt package. Some senior advisers are urging him to stimulate the economy, and he has responded with a wage hike and has increased protection for domestic industry. Pinochet may also replace his economic team next year. The delays in disbursements from the recently concluded debt package could reduce growth even more and shrink real wages for the fourth year in a row. 25X1 This, coupled with continuing political protests and uneasiness within the armed forces, might persuade Pinochet to change his economic team sooner and revert to expansionary policies. Such actions, however, would risk alienating foreign creditors and raise the danger of a foreign exchange crisis. [redacted] 25X1

Iran's Austerity Budget Reflects Problems

On Sunday Prime Minister Musavi presented the Consultative Assembly a budget for the fiscal year beginning next March that calls for negligible growth in spending. A 12.5-percent increase in defense outlays would be offset by cuts in most other domestic spending. As a result, real nondefense spending probably will fall by at least 15 percent next year, aggravating economic hardships. In real terms, defense expenditures probably will remain about the same. Musavi's emphasis on developing domestic defense industries suggests that purchases of military hardware from abroad will not increase. Musavi said Iraqi attacks on Khark and the soft oil market have kept oil income—more than half of government revenue—40 percent below projections for the current fiscal year. Expected declines in oil income next year would be offset by doubling domestic borrowing—Musavi warned this was necessary to avert recession despite the inflationary effects. The assembly, already at odds with Musavi over some of his radical economic policies, is likely to insist on even further cuts in domestic spending to avoid this increased borrowing. [redacted] 25X1

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Iraq Seeks US Technology

Iraq is seeking to increase ties to US firms to obtain US technology for economic development. [redacted] 25X1

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[redacted] According to the US Embassy, Iraq believes closer economic ties will strengthen relations with the United States and help offset political differences, such as US support for Israel [redacted] 25X1

Indonesia's Current Account Deficit Widens

According to US Embassy reporting, Indonesia's current account deficit for the first half of the fiscal year beginning 1 April reached $1.5 billion, about twice the level recorded in the same period a year earlier. The deterioration resulted from a 30-percent reduction in oil and gas revenues. Jakarta expects some improvement in the second half, resulting in a yearend deficit of $2.8 billion. In our view, however, these figures are optimistic because of the continued weakness of oil prices. Oil prices may fall below $20 per barrel during the next 18 months. Despite government efforts to trim imports, a growing current account deficit would cut into Jakarta's $10.5 billion in total foreign reserves and require a significant increase in the country's $34 billion external debt to keep the economy growing. [redacted] 25X1

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Indonesia's Surging Budget Revenues

Provisional data for the first six months of the current fiscal year (1 April–31 March) indicate that total government revenues amounted to roughly $8.7 billion—a 15-percent increase over the same period for the previous fiscal year—despite a dramatic decline in oil export revenues, which provide more than half of all government income. The US Embassy reports the surge reflects increased government efficiency in tax collection. In particular, the value-added tax instituted last year has surpassed the income tax as the most reliable source of nonoil government revenue. According to Finance Minister 25X1

Prawiro, Jakarta is committed to making up for falling petroleum revenues by cracking down on tax evaders and through further revisions in property and stamp taxes. These efforts to mobilize national savings to pay for domestic development programs, however, probably will have limited success in closing the estimated $1 billion budget deficit for fiscal year 1985. [redacted] 25X1

Singapore Averting Financial Crisis

The unprecedented closure of Singapore's stock exchange on 2 December will blemish the country's reputation as a reliable financial center. Last Friday, 30 creditors of the floundering Pan Electric—a large firm with subsidaries in five other countries—failed to agree on a plan to restructure debts of over US $190 million. The company was then placed in receivership. Fearing investor panic, the government suspended stock trading—a move that prompted Malaysia to suspend trading on its exchange in Kuala Lumpur. Because US $160 of Pan El's assets have been used to secure an estimated US $350-400 million of private debt incurred by shareholders, its collapse endangers several large brokerage firms. By Wednesday the government had persuaded banks to cover brokers' cash flow problems and promised tighter control over the stock exchange by the central bank, enabling the exchange to reopen Thursday. Pan El's troubles—overinvestment in failing real estate, hotel, and electronics enterprises—are common among companies in Singapore. The government must now convince the public that Pan El's collapse is not the first of a long string of bankruptcies in a year already marred by the first contraction of the economy in decades. [redacted] 25X1

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Taiwan Settling The ADB Stalemate

Taiwan has apparently decided to remain in the Asian Development Bank (ADB) after China becomes a member. [redacted] Premier Yu Kuo-hua indicated that Taipei has decided to remain in the Bank but is unhappy with the US-supported name change "Taipei, China." The Foreign Ministry's press statement on China's application to join the Bank was less hard line than previous statements on the ADB and simply noted Taipei's hope that the ADB would work out a fair and rational solution that would not harm Taiwan's interests. Taiwan's decision to remain in the ABD would represent a victory for senior government and military officials who had feared withdrawal would be a psychological gain for China and could harm Taiwan's already strained relations with Washington. Taipei may now hope that it has quieted domestic critics by not retreating from its "principled stand" on the nomenclature issue and has built a case that it was forced to accept "Taipei, China" under pressure from Washington. [redacted]

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Communist

Soviet Grain Purchases Down

Soviet grain buying in the first five months of the current market year is running about 30 percent behind last year's pace. [redacted] the USSR has bought 15 million tons of wheat and coarse grains. Less

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than half has been delivered, with the remainder to be delivered by next March. US grain sales to the USSR are running even further behind. Wheat sales are only 152,600 tons compared with 6.8 million tons by this time last year; corn sales are running nearly 60 percent below last year, at 3.8 million tons. Slack US sales reflect lower prices of competitors—$30 to $40 less per ton for wheat—and Soviet anger at not receiving the lower prices available under the US export subsidy program. Canada has already sold over 4 million tons of grain. French wheat sales of 4 million tons already total two-thirds of yearly expected EC sales. Soviet purchases of Argentine wheat—reportedly 1.5 million tons—are about on a par with the 1985 pace. Soviet grain buying is expected to pick up in January-March, but for the 1986 market year total imports will probably reach only 25-30 million tons, as much as 50 percent below last year. Total Soviet purchases of US grain could dip as low as 9 million tons compared with 22 million tons last year. [redacted] 25X1

East German Economic Plans for 1986

East Germany's economic plan and state budget for 1986 released on 29 November suggest that East Berlin will continue most of its current economic policies into the first year of the new five-year plan. Projected national income growth of 4.4 percent is the same as this year's target. Production of lignite is to rise 6 percent, further reducing East German dependence on imported, mainly Soviet, energy. A 13-percent increase in investment reverses the declines of recent years and could indicate increased capital goods purchases from the West. Steel production is to reach 9.2 million tons, up from 7.6 million tons in 1984, which probably reflects completion of a new Austrian-built mill. The state budget includes another big increase in subsidies for consumer goods. Also noteworthy is a 7.7-percent increase in defense spending, a slightly higher growth rate than in recent years. The targets for 1986 are attainable, but the regime will have to overcome a host of problems to keep growth as high through 1990. [redacted] 25X1 25X1

Czechoslovak Investment Program

Czechoslovakia has announced an investment plan for 1986-90 that will focus on problems of technological stagnation, energy dependence, uncompetitive exports, and pollution. The plan calls for average annual investment growth of 3.5 percent, compared with the 0.4-percent average during 1981-85. Even this higher level would probably be insufficient to achieve the regime's ambitious goals for modernizing the obsolescent capital stock. Prodded by Moscow's demand for more and better goods, the program emphasizes investment in robotics, electronics, and some chemicals, as well as those industries, such as tractors and trucks, for which it is a major supplier to CEMA. To counter some of the worst pollution in Eastern Europe, investment in environmental protection will almost double that of the previous five years. Prague will continue substituting nuclear power for fossil fuels, doubling the nuclear share of total energy to almost one-third by 1990. [redacted] 25X1 25X1

China To Cut Fertilizer Imports

[redacted] Chinese officials stated that they have no immediate plans to import any phosphate fertilizer or potash. Early this year, China's fertilizer importer, Sinochem, 25X1

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increased imports, thinking that China's new agricultural reforms would increase demand for fertilizer. Local press reports indicate, however, that fertilizer usage dropped dramatically, as profit-seeking peasants minimized their use of farm inputs. In addition, transportation problems slowed fertilizer distribution, contributing to large stockpiles. Chemical industry officials have cut back domestic fertilizer production and temporarily shelved expansion plans. Although Western firms are hoping for rush orders in early 1986, we do not expect Chinese fertilizer purchases next year to match previous years' imports. [redacted] 25X1

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